No. 7543

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IN THE

United States Circuit Court of Appeals

FOR THE

NINTH CIRCUIT

EDMUND J. LORD,
Appellant,

vs.

TERRITORY OF HAWAII,
Appellee.

UPON APPEAL FROM THE SUPREME COURT OF THE TERRITORY OF HAWAII

BRIEF FOR APPELLEE

W. B. PITTMAN,
Attorney General of the Territory of Hawaii;

JOSEPH V. HODGSON,
GEORGE P. KIMBALL,
JON WIIG,
Deputy Attorneys General of the Territory of Hawaii;
Attorneys for the Territory of Hawaii.

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BRIEF FOR APPELLEE

I.

STATEMENT OF FACTS

In the year 1931 the appellant filed in the First Taxation Division of the Territory of Hawaii, an income tax return for the twelve months preceding January 1, 1931. The return showed, amongst other income, income in the amount of $408,219.98 received from E. J. Lord, Limited, a corporation, which income appellant claimed to be exempt from taxation for the alleged reason that it was dividends received from a corporation which was subject to and had paid a territorial income tax (Record, pages 1 to 7). Thereafter the income tax assessor notified the appellant that the return was not in conformity to law and assessed the appellant upon net taxable income in the

amount of $398,224.40 (the amount of the aforesaid income claimed to be exempt together with other income less certain deductions and exemptions) a territorial income tax in the amount of $18,686.22 (Record, pages 8 to 11).

From this assessment the appellant appealed to the Territorial Board of Equalization (Record, pages 11 to 13). Upon the hearing of the appeal, both the appellant and the Territory of Hawaii adduced evidence (Record, pages 38 to 278). The Territorial Board of Equalization sustained the contentions of the Territory and, after finding particular facts (Record, pages 14 to 17), made findings that the amount of $408,219.98 was not intended as or received by the appellant as dividends, but, to the contrary, that the said amount was taxable income derived from the sale of stock by the appellant to E. J. Lord, Limited, the corporation. Upon all of the evidence the Territorial Board of Equalization concluded that "this Board finds for the tax assessor and hereby decides that the taxpayer had for the twelve months preceding January 1, 1931, a taxable income of $398,224.40 on which a territorial income tax amounting to $18,686.22 shall be paid" (Record, pages 18 and 19).

Thereafter the appellant appealed from the decision of the Territorial Board of Equalization to the Supreme Court of Hawaii (Record, pages 19 to 21). The Supreme Court of Hawaii rendered its decision (32 Hawaii, 896), which, after carefully reviewing the evidence and the contentions of the parties, found that the amount received

by the appellant was not received as a dividend. It found that the transaction, out of which the said sum was received, was a sale by the appellant to E. J. Lord, Limited, of 600 shares of the latter's stock. It decided that the amount received was taxable income.

The Supreme Court affirmed the decision of the Territorial Board of Equalization. A judgment was thereafter entered in conformity to the decision (Record, pages 37 and 38). From this decision and judgment the appellant appealed to this Honorable Court.

The material facts are stated in the said decision of the Supreme Court (Record, pages 24 to 31). We adopt the statement of facts made by the Supreme Court. The Supreme Court said:

> "E. J. Lord and E. E. Black, having been prior thereto associated in the contracting and building business, in September, 1926, formed a corporation under the name of E. J. Lord, Limited. The corporation had a capital stock of $100,000 in one thousand shares, six hundred shares of which were issued to E. J. Lord and four hundred shares to E. E. Black, Lord contributing in payment of the stock money or other capital of the value of $60,000 and Black contributing money or other capital of the value of $40,000. Apparently to comply with the requirements of the law relating to the formation of corporations, three other stockholders were named, each as the holder of one share, but, as testified to by Black at the trial before the board, these three held the shares only 'nominally' and were in reality 'dummies.' In each of the annual reports subsequently filed with the treasurer of the Territory only two persons were named as holders of the capital stock and these

were E. J. Lord as holding six hundred shares and E. E. Black as holding four hundred shares.

The corporation met with a large measure of success and received substantial profits from its operations.

Late in 1929 E. E. Black, whose ambition had long been to form and control a corporation of his own, and E. J. Lord, who, because of ill health and perhaps for other reasons, desired to retire from the active pursuit of that business, after various discussions came to the understanding that Lord would retire and that Black would continue the business. On December 13 of that year they signed a written document which had been prepared by learned counsel, a former chief justice of this court, stating the terms of the understanding which the two had so reached. There was included in the agreement the grant to E. J. Lord Company, Limited, of an option to acquire the six hundred shares owned by E. J. Lord, for a consideration therein stated. Shortly thereafter the option was accepted by the corporation and in due course, in part early in 1930 and in part in December of 1930, the sum of $468,219.98 was paid to Lord in accordance with the terms of the contract.

Subsequent to the acceptance of the option the name of the corporation was changed to E. E. Black, Limited, and its capital stock was reduced to $40,000 divided into four hundred shares, all of which was held by E. E. Black. * * *

The main question is, what was the nature of the transaction between the corporation and Lord? As to the $60,000 there is no dispute. It was a restoration to Lord of the capital which he had contributed. As to the remainder, was it received by Lord as a dividend? The board of directors of E. J. Lord, Limited, held a meeting on December 7, 1929, to consider the proposal then pending. Under the title of 'Purchase of Stock' the minutes of that meeting say: 'Mr. E. E. Black moved that as Mr. E. J. Lord was willing to

sell all his stock of E. J. Lord, Ltd., the company was to redeem the 600 shares for which the company was to pay for the said shares in the following manner: (1) The sum of money equal to 60% of the net worth of the company as of December 31st, 1929; (2) the sum of money equal to 60% of the net profits of all contracts awarded and not completed on December 31, 1929; (3) the sum of money equal to 40% of the amount to which Mr. E. J. Lord may become liable for federal and territorial income taxes upon income accrued and to accrue to him resulting from the sale of said 600 shares. Mr. Lord agreed to give the company an option to purchase the above mentioned stock to February 28th, 1930, and to have an agreement drawn signed by both parties covering the above option, price and payments to be made, a copy of such agreement to be entered into the minute book.' This motion carried unanimously. Another motion adopted at the same meeting was: 'That the company upon the exercise of the option cause its articles of association to be amended' so as to effectuate a change of name.

Then followed the carefully drawn agreement of December 13, 1929, which was intended, as appears from the evidence, to be a written record of what the agreements were. Omitting irrelevant portions, that instrument recited and declared, referring to E. J. Lord's six hundred shares of capital stock, that the corporation 'desires to redeem said shares of stock'; that Lord 'is willing to accept as consideration for the sale of said stock' to the corporation and the corporation 'is willing to pay' to Lord 'for the redemption of said stock, a sum of money equal to sixty per cent (60%) of the net worth' of the corporation 'as of December 31, 1929, and a sum of money equal to sixty per cent (60%) of the net profits yet to accrue' to the corporation 'by its completion of the respective works contemplated by certain executory contracts to which' the corporation 'is a party, remaining uncom-

pleted, and the further sum of money equal to forty per cent (40%) of the amount to which' Lord 'may become liable to the United States of America and/or the Territory of Hawaii for income taxes upon income accrued and/or to accrue to him by reason of and resulting from the exercise' by the operation 'of the option hereby granted and the consummation of the sale of said six hundred (600) shares of the capital stock' of the corporation; that 'the net worth of the' corporation 'cannot be determined until the books' of the corporation 'have been closed for the year 1929 and an audit made thereof;' that certain enumerated contracts were uncompleted; that therefore Lord 'does hereby * * *' (a) 'give and grant' to the corporation 'an option, irrevocable within the time for acceptance herein limited, to purchase free from encumbrances the said six hundred (600) shares of the capital stock' of the corporation 'so owned by him * * * for the consideration hereinafter set forth,' (b) 'assign and deliver' to the corporation the same six hundred shares, duly endorsed, 'by way of pledge to secure the performance' of Lord's covenants and (c) appoint the corporation his attorney 'upon the exercise of the option hereby granted' to cause the said six hundred shares 'of the capital stock * * * to be redeemed' by the corporation and 'to be recorded on the proper books' of the corporation. The corporation, on the other hand, agreed (1) to close its books as of December 31, 1929, and to have them audited, (2) to faithfully complete the uncompleted contracts in as economical manner as possible, (3) to have its books open to the inspection of Lord at all times and (4) that 'upon the exercise of the option by it to it hereby granted,' it will 'as soon as may be, cause its articles of association to be amended' so as to effectuate the desired change of name. Both parties mutually covenanted and agreed therein (1) that 'the option hereby given shall be open for acceptance up to, but not after the 28th day of February, 1930,'

(2) that 'the purchase price of the said stock' should be, reciting the precise language earlier in the document used, 'a sum of money equal to sixty per cent (60%) of the net worth' of the corporation as of December 31, 1929, 'a sum of money equal to sixty per cent (60%) of the net profits yet to accrue' to the corporation 'by its completion' of the uncompleted contracts and 'the further sum of money equal to forty per cent (40%) of the amount' which Lord 'may become liable' to pay 'for income taxes upon income accrued and to accrue to him by reason of and resulting from the exercise' by the corporation 'of the option hereby granted and the consummation of the sale' of the six hundred shares. The document further recites 'that such purchase price shall be paid' to Lord as follows: 'The sum of money equal to sixty per cent (60%) of the net worth' of the corporation 'as of December 31, 1929, forthwith upon the exercise' by the corporation 'of the option hereby granted to it. In the event that the amount so payable exceeds the sum of two hundred fifty thousand dollars ($250,000.00), the amount of the excess over that sum may be retained' by the corporation 'until and paid by it to' Lord 'upon the completion of the St. Louis Heights contract and the receipt by it of the full consideration for the performance thereof, the sum of money equal to sixty per cent (60%) of the net profits yet to accrue from each of the foregoing enumerated uncompleted contracts when completed and the moneys, bonds or other consideration accrued and payable or deliverable' to the corporation 'thereunder, reduced to possession, and the sum of money equal to forty per cent (40%) of the income tax' which Lord might become liable to pay 'for income taxes upon income accrued or to accrue to him by reason of and resulting from the exercise by' the corporation 'of the option hereby granted and the consummation of the sale' of the six hundred shares 'forthwith upon assessment.'

> Under date of February 15, 1930, Lord signed a paper whereby he acknowledged receipt of the sum of $250,000 in money or its equivalent, from the corporation, which paper read as follows: 'E. J. Lord, Limited, having duly accepted the option granted by me to it by the indenture of agreement between us dated December 13, 1929, and the sum of two hundred seventy-three thousand eight hundred fifty-five dollars and thirty-six cents ($273,855.36) having been found to be sixty (60%) of the net worth of E. J. Lord, Limited, as of December 31, 1929; I hereby accept in lieu of cash and acknowledge receipt from E. J. Lord, Limited, in payment of the sum of two hundred fifty thousand dollars ($250,000.00) on account of the purchase price of the six hundred (600) shares of the capital stock of E. J. Lord, Limited, the subject of said indenture, the following enumerated notes, bonds and cash,'—followed by an enumeration of the property transferred and received."

II.

APPELLANT'S "ANALYSIS OF THE CASE"

The decision of the Supreme Court is a complete answer to every contention and argument made by the appellant. The Supreme Court carefully considered all of the evidence. Its decision is in accord with the findings made by the Territorial Board of Equalization. Those findings are supported by abundant evidence throughout. It correctly construed the territorial income tax statute (Chapter 103, Revised Laws of Hawaii 1925). Its construction is in accord with the construction given the statute by the administrative officers (Record, pages

233 to 241, 260, 261). It then applied the law to the facts and arrived at the inevitable result that the assessment should be sustained and the decision of the Territorial Board of Equalization affirmed. The decision is sound in every respect, and its language and meaning too clear to admit of any argument.

The appellant has failed to show wherein the Supreme Court erred in any particular. He does not argue that there was an absence of evidence or insufficient evidence to support the findings made in the decisions he has appealed from. His entire argument is directed to the points, first, that the administrative officials, and then the Territorial Board of Equalization, and then the Supreme Court erroneously construed a local territorial income tax law, and, second, that the findings of fact should have been made in conformity to his interpretation of the evidence. He desires this court to construe a local territorial tax statute differently than the highest court of the Territory has construed it. He wants this court to make findings of fact contrary to those of the Territorial Board of Equalization and the Supreme Court.

It should be observed that the appellant's two contentions, namely, that the amount ($408,219.98), received by the appellant from E. J. Lord, Limited, was received by him as a "dividend," (appellant's brief, pages 11 to 37), and, that even though the moneys were not received by appellant as a "dividend" still no tax was assessable thereon because the increase in value of the shares sold accrued during the years 1926 to 1930, both years inclusive (ap-

pellant's brief, pages 37 to 46), were made before the Supreme Court (Record, pages 26 and 27). The Supreme Court fully considered both contentions and fully disposed of them (Record, pages 31 to 37).

The only contention not made before the Supreme Court is that contained in the last paragraph of appellant's brief, immediately before its "conclusion." This contention was not advanced before the Territorial Board of Equalization nor the Supreme Court. It is not covered or raised by the assignment of errors.

Beside the points, hereinafter made, as to the issues before this Honorable Court upon an appeal from the Supreme Court, the principal question in the case at bar is whether the transaction between Lord and the corporation, E. J. Lord, Limited, was a sale of stock by Lord to the corporation, from which sale he derived the income assessed by the Territory, or whether the corporation paid out, and Lord received a dividend. That issue is clearly set forth in the decision of the Supreme Court. The Supreme Court did not answer that question from the form of the transaction alone, as stated by the appellant on pages 9 and 10 of his brief, but it considered all of the evidence. It reviewed the evidence and considered the evidence of Black (Record, pages 24 and 25), the minutes of the corporation (Record, pages 27 and 29), the written agreement (Record, pages 28 to 31), the payments made to and the receipts given by Lord and all of the testimony (Record, page 32). The court said at page 32, "* * * The essence of the transaction, as disclosed by

the minutes of the corporation, by the formal memorandum of contract, by the formal receipt *and by the testimony*† is that Lord sold to the corporation * * * the six hundred shares of stock * * *." After considering all of the evidence it decided that the formal agreement of sale correctly set forth the nature of the transaction and the intention of the parties.

III.

CONTENTIONS OF THE APPELLEE

The appellee, the Territory of Hawaii, respectfully contends:

1.

That the decision of the Supreme Court of Hawaii involves and is based upon the construction of a local statute, and, that the Honorable, the United States Circuit Court of Appeals, should not disturb such a decision.

2.

That the decision of the Supreme Court of Hawaii involves issues and findings of fact, which findings are supported by substantial evidence, and that the Honorable, the United States Circuit Court of Appeals should not, under such circumstances, disturb the same.

3.

That the amount received by the appellant from the corporation, E. J. Lord, Limited, in consideration of his

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† (Italics supplied unless indicated otherwise.)

selling to the said corporation 600 shares of stock, was not a "dividend" within the meaning of that term as it is used in Section 1391 of the Revised Laws of Hawaii, 1925.

4.

That the amount received by the appellant from the corporation, E. J. Lord, Limited, was taxable income derived from the sale of 600 shares of stock.

5.

That the exemption claimed by the appellant should not be construed in his favor, but should be strictly construed in favor of the government.

6.

That the court did not err in holding that the difference between the cost of appellant's stock and the amount he received therefor was taxable.

7.

That the tax upon the income of the appellant for the year 1930 was correctly computed.

8.

That the appellant has waived any objection to the computation of the tax.

9.

That the assignments of error do not raise for review the question as to whether the tax was correctly computed.

IV.

ARGUMENT.

1.

THAT THE DECISION OF THE SUPREME COURT OF HAWAII INVOLVES AND IS BASED UPON THE CONSTRUCTION OF A LOCAL STATUTE, AND, THAT THE HONORABLE, THE UNITED STATES CIRCUIT COURT OF APPEALS, SHOULD NOT DISTURB SUCH A DECISION.

It not only appears from the entire record, and particularly from the decision of the Supreme Court of Hawaii (Record, pages 25, 26, 34, 35 and 36), but it also appears from appellant's argument that a construction of Chapter 103, Revised Laws of Hawaii, 1925, the Territorial income tax statute is involved. The Supreme Court of Hawaii said in its decision: "Subsequent to the acceptance of the option the name of the corporation was changed to E. E. Black, Limited, and its capital stock was reduced to $40,000 divided into four hundred shares, all of which was held by E. E. Black. Section 1391, R. L. 1925, which is part of chapter 103, relating to income taxes, provides that 'in assessing the income of any person or corporation there shall not be included the amount received from any corporation as dividends upon the stock of such corporation if the tax of two per centum has

been assessed upon the net profits of such corporation as required by this chapter.' It is undisputed that the money paid to E. J. Lord under the contract referred to, other than the sum of $60,000 which came from capital, was actually paid by the corporation out of undivided profits, partly earned prior to the date of the contract and partly earned after the date of the contract and that upon all of these undivided profits the corporation had paid the tax of two per cent required by law. The contention of the taxpayer-appellant is that the moneys received by him in 1930 (other than $60,000 thereof) were received by him 'as a dividend' out of profits which had already borne the statutory tax of two per cent and are, therefore, exempt from taxes as income of E. J. Lord. The contention of the Territory, on the other hand, is that in the transaction between Lord and Black there was not any payment of a dividend and that there was simply a sale by Lord and a purchase by the corporation of the six hundred shares of the capital stock owned by Lord and a payment therefor of the purchase price in which was not involved or included any idea of a dividend. A second claim by the appellant is that even if the moneys in question were not received by Lord 'as a dividend' but are to be deemed gains or profits derived from the sale of personal property, still no tax is assessable thereon because the increase in value of the six hundred shares over and above $60,000 accrued during the years 1926, 1927, 1928 and 1929 and did not accrue wholly during the taxation year of 1929." (Record, pages 25 and 26.)

The court was called upon to determine whether the words of the statute "the amount received from any corporation as dividends upon the stock of such corporation" included the amount received by the appellant (other than $60,000 thereof) from the corporation, E. J. Lord, Limited, upon the sale of his stock. The appellant contended that it was included, and the Territory maintained that it was not included. Hence, a question of statutory construction is involved.

The following language clearly shows that the Supreme Court of Hawaii was faced with the construction of a Hawaiian statute:

> "Another consideration, not controlling and yet relevant, is that the exemption provided for in the provisions of section 1391, above quoted, is that in favor of amounts received from a corporation 'as dividends upon the stock' of that corporation. This would seem to presuppose the payment of a dividend to one who holds stock rather than to one who by the very transaction is relinquishing the stock to the corporation. If the legal possibility of one who is relinquishing stock in the same transaction receiving a dividend upon that stock is not excluded, at least it would require some evidence on the part of the parties to the transaction to indicate that some or all of the moneys paid to the outgoing stockholder were being paid as a dividend. There are no such indications in the case at bar." (Record, page 34.)

The second contention made by the appellant also involves the construction of the same statute. This clearly appears from the decision of the Supreme Court of Hawaii. It said: "The other contention of appellant likewise

cannot be sustained. Section 1388, R. L. 1925, provides that 'there shall be levied, assessed, collected and paid annually upon the gains, profits and income received by every individual residing in the Territory, from all property owned, * * * a tax in accordance with the following schedule on the amount so received during the taxation period.' The schedule of rates of taxation follows. Section 1390 provides that 'in estimating the gains, profits and income of any person or corporation, there shall be included * * * the amount of sales of all movable property, less the amount expended in the purchase or production of the same * * * and all other gains, profits and income derived from any source whatsoever during said taxation period.' In the face of this language of the statute, the contention that the profits resulting from the sale of stock were not taxable in January, 1931, because they did not wholly accrue during the year 1930, is untenable. The requirement of the statute was that in January, 1931, liability would accrue for taxes on income which was 'received' or 'derived' during the taxation period, which was the year 1930; and this is made even more clear with reference to the sales of movable property when the statute declares that in estimating the profits 'there shall be included * * * the amount of * * * less the amount expended in the purchase.' The legislature did not, in this connection, make any exception of those parts of the gain in value which did not accrue during the taxation year and the court cannot now make the exception." (Record, pages 35 and 36.)

The second contention is purely one of statutory construction.

This Honorable Court, as well as the Supreme Court of the United States, has repeatedly held, in a long line of decisions, that it is desirable that questions involving the construction of territorial statutes be settled by the decision of the Supreme Court of Hawaii. In *Territory of Hawaii v. Gay,* 52 F. (2d) 356, this Honorable Court in affirming a decision of the Supreme Court of Hawaii in respect to a question relating to Hawaiian land tenure, had occasion to enumerate the many decisions enunciating this principle. The court said, at page 359:

> "It is desirable that such questions be settled by local legislation and decision. This has been the consistent view of the Supreme Court of the United States (Kealoha v. Castle, 210 U.S. 149, 28 S. Ct. 684, 52 L. Ed. 998; Cotton v. Hawaii, 211 U.S. 162, 29 S. Ct. 85, 53 L. Ed. 131; Lewers & Cooke v. Atcherly, 222 U.S. 285, 32 S. Ct. 94, 56 L. Ed. 202; Kapiolani Estate, Ltd. v. Atcherley, 238 U.S. 119, 35 S. Ct. 832, 59 L. Ed. 1229, Ann. Cas. 1916E, 142; John Ii Estate v. Brown, 235 U.S. 342, 35 S. Ct. 106, 59 L. Ed. 259; Cardona v. Quinones, 240 U.S. 83, 88, 36 S. Ct. 346, 60 L. Ed. 538), and of this court (Ewa Plantation Co. v. Wilder (C.C.A.), 289 F. 664, 670; Territory of Hawaii v. Hutchinson Sugar Plantation (C.C.A.), 272 F. 856; Castle v. Castle (C.C.A.), 281 F. 609; Halsey v. Ho Ah Keau (C.C.A.), 295 F. 636; Notley et al. v. McMillan (C.C.A.), 16 F. (2d) 273; Honolulu Rapid Transit Co. v. Wilder (C. C.A.), 36 F. (2d) 159; U. S. Fidelity & Guaranty Co. v. Henry Waterhouse Trust Co. (C.C.A.), 11 F. (2d) 497)."

In *Yoshizawa v. Hewitt,* 52 F. (2d) 411, at page 413, this Honorable Court, in considering a question involving Hawaiian laws respecting members of the board of health, said:

> "In view of the fact that the statutory construction here is one of purely local law, and the Supreme Court of the territory has given its interpretation thereof, we see no reason for disturbing the judgment of the latter.
>
> 'Even if the statute is ambiguous, doubt as to its meaning should be resolved in favor of the construction placed upon it by the Supreme Court of the territory. Clason v. Matko, 223 U.S. 646, 32 S. Ct. 392, 56 L. Ed. 588; Ewa Plantation Co. v. Wilder (C.C.A.) 289 F. 664, 670, and cases there cited.' U.S. Fidelity & Guaranty Co. v. Henry Waterhouse Trust Co., Ltd. (C.C.A.) 11 F. (2d) 497, 499.
>
> '* * * The construction placed upon a local law * * * by the highest court of the Territory will not be disturbed by an appellate court. Kealoha v. Castle, 210 U.S. 149, 28 S. Ct. 684, 52 L. Ed. 998; Cotton v. Hawaii, 211 U.S. 162, 29 S. Ct. 85, 53 L. Ed. 131; Lewers & Cooke v. Atcherly, 222 U.S. 285, 32 S. Ct. 94, 56 L. Ed. 202; John Ii Estate v. Brown, 235 U.S. 342, 35 S. Ct. 106, 59 L. Ed. 259; Hawaii County v. Halawa Plantation, Limited (C.C.A.) 239 F. 836; Territory of Hawaii v. Hutchinson Sugar Plantation Co. (C.C.A.) 272 F. 856; Castle v. Castle (C.C.A) 281 F. 609; Ewa Plantation Co. v. Wilder (C.C.A.) 289 F. 664; Halsey v. Ho Ah Keau (C.C.A.) 295 F. 636.' Notley et al. v. McMillan (C.C.A.) 16 F. (2d) 273."

In the case of *Ewa Plantation Company v. Wilder,* 289 Fed. 664, in affirming a decision of the Supreme Court of Hawaii involving the construction of the Terri-

torial income tax laws, this Honorable Court said at page 670:

> "Another consideration which we consider a conclusive reason for affirming the judgment is that in all cases involving the construction of local territorial statutes, an appellate court must lean toward the interpretation adopted by the Supreme Court of the territory, and will not disturb its decision unless there is clear error. Cardona v. Quinones, 240 U.S. 83, 36 Sup. Ct. 346, 60 L. Ed. 538; Lewers & Cooke v. Atcherly, 222 U.S. 285, 34 Sup. Ct. 94, 56 L. Ed. 202; Kealoha v. Castle, 210 U.S. 149, 28 Sup. Ct. 684, 52 L. Ed. 998. The rule so established has been followed by this court in Kinney v. Oahu Sugar Co., 255 Fed. 732, 167 C. C. A. 78; Castle v. Castle (C.C.A.) 281 Fed. 609; Territory of Hawaii v. Hutchinson Sugar P. Co. (C.C.A.) 272 Fed. 856; and In re Bishop's Estate, 250 Fed. 145, 162 C.C.A. 281.
>
> The judgment is affirmed."

Likewise, in *Honolulu Rapid Transit Co. v. Wilder,* 36 F. (2d) 159, the construction of an Hawaiian tax law was involved in the decision of the Supreme Court of Hawaii. This court said at page 160:

> "The first question thus presented involves the construction of local tax laws, and the rule is well settled that an appellate court will not disturb the construction placed on such laws by the Supreme Court of a territory, except for manifest error. Fox v. Haarstick, 156 U.S. 674, 679, 15 S. Ct. 457, 39 L. Ed. 576; Copper Queen Mining Co. v. Arizona Board, 206 U.S. 474, 479, 27 S. Ct. 695, 51 L. Ed. 1143; English v. Arizona, 214 U.S. 359, 29 S. Ct. 658, 53 L. Ed. 1030; Notley v. McMillan (C.A.A.) 16 F. (2d) 273."

Hill v. Carter, 47 F. (2d) 869, involved the construction of the aforementioned Section 1388, Revised Laws of Hawaii 1925. In affirming the decision of the Supreme Court of Hawaii this Honorable Court said at page 870:

> "This case comes within the rule frequently announced by this and other courts, to the effect that 'an appellate court must lean toward the interpretation adopted by the Supreme Court of the territory, and will not disturb its decision unless there is clear error.' Ewa Plantation Co. v. Wilder (C.C.A.) 289 F. 664, 670. While a dissenting opinion was filed in the court below, we are not impressed that the reasoning of the majority opinion was in error. At least it does not clearly so appear."

The above mentioned seventeen decisions, all involving appeals from the Supreme Court of Hawaii, are an impressive line of precedents. We respectfully submit that the construction placed upon Sections 1388, 1390 and 1391 Revised Laws of Hawaii 1925, by the highest court of the territory, should not be disturbed by an appellate court. The appellant fails to show any "manifest error" or "clear error" in the construction placed upon the aforementioned territorial income tax statutes by the Supreme Court of Hawaii.

That the appellant realized that his contentions were opposed to the long line of precedents above mentioned, is disclosed by pages 10 and 11 of his brief. He states: "Nor is any question of local statutory construction at issue in this case. In its decision the Supreme Court tacitly conceded that the statute in question could cover

the type of transaction in question * * *." The appellant's last statement has no bearing on the matter,—the statute covers the entire transaction. The Supreme Court of Hawaii decided that the amount of $408,219.98, paid to the appellant, was not "dividends" within the meaning of that term as it is used in said Section 1391, but was taxable income within the meaning of other sections of the statute. It decided that the said amount was "received" or "derived" by the appellant during the "taxation period," within the meaning of those terms as they are used in said sections 1388 and 1390.

The appellant then proceeds: "On the Supreme Court's own analysis of the problem the question presented is purely and simply: What was the essential character of the transaction in question?—and that is the question which this brief will consider." In determining whether the amounts paid to Lord were "dividends upon the stock" of the appellant the Supreme Court of Hawaii inquired into the findings made by the Territorial Board of Equalization. This necessitated a review of the evidence. After determining that the findings were supported by abundant evidence, the Supreme Court then construed the statutes. Hence, "the question presented" was not "purely and simply" the one mentioned.

After making the foregoing assertions the appellant contradicts the same when he states, on page 38 of his brief, that: "Unquestionably we are here in the realm of 'local statutory instruction' of tax laws." Apparently, "construction" is meant for "instruction."

It is clear from the quotation from *Castle v. Castle,* 267 F. 521, cited on page 11 of appellant's brief, that appellant realized that his contentions were in the realm of local statutory construction. The quotation shows that the Castle case has no application to the case at bar.

2.

THAT THE DECISION OF THE SUPREME COURT OF HAWAII INVOLVES ISSUES AND FINDINGS OF FACT, WHICH FINDINGS ARE SUPPORTED BY SUBSTANTIAL EVIDENCE, AND THAT THE HONORABLE, THE UNITED STATES CIRCUIT COURT OF APPEALS, SHOULD NOT, UNDER SUCH CIRCUMSTANCES, DISTURB THE SAME.

The only law involved in the instant case is the territorial income tax statute. The appellant, as pointed out, maintains that the statute is not involved. Hence, assuming arguendo that the appellant's assertion is correct, then the facts must be involved. However, although the appellant argues in his brief to great length about the facts and the findings made thereon, he states on page 10 that: "We should like to make it clear that no question of reviewing conflicting evidence or disturbing any finding of fact is here involved. The facts are undisputed. The question is simply one of determining the intention of the parties from all of those facts, rather than confining our inquiry to the form of the transaction and to some of the

facts." The appellant's dilemma is apparent. If the law is not involved, the findings of fact must be involved.

Moreover, although appellant states in one sentence "that no question" of "disturbing any findings of fact" is involved, he next states that the "question is simply one of determining the intention of the parties." Apparently, he does not realize that "the intention of the parties" is a question of fact. The Territorial Board of Equalization, which had the witnesses before it and observed their demeanor on the witness stand and examined the documentary evidence, found E. J. Lord, Limited, "intended the transaction to be wholly a sale" (Record, page 15). The board based this finding upon both written and oral evidence (Record, pages 15 to 17). The board further found "The records do show that a sale was intended and was consummated." (Record, page 18.)

The Supreme Court in reviewing these findings said: "The main question is, what was the nature of the transaction between the corporation and Lord? As to $60,000 there is no dispute. It was a restoration to Lord of the capital. As to the remainder, was it received by Lord as a dividend?" (Record, page 27.) The court then proceeded to review the abundant evidence supporting the board's findings (Record, pages 27 to 32) and concluded that the findings were supported by the weight of the evidence. It stated, "The essence of the transaction, as disclosed by the minutes of the corporation, by the formal memorandum of contract, by the formal receipt and by the testimony, is that Lord sold to the corporation and that the

corporation bought back (that is what the word 'redeem' means) from him six hundred shares of stock" (Record, page 32). Thus, whether considered as a review of the board's said findings or as an independent finding, the Supreme Court decided what the parties' intentions were.

That the Supreme Court reviewed and sustained the board's findings as to the "intention of the parties" is clearly shown by its statement "It is not for us to consider now what the parties might have done. What is before us for consideration is, what did they actually do? This is necessarily, in large measure, *a question of the intention of the parties.* The instruments and records above cited are susceptible of only one interpretation in that respect and that is that the parties *understood and intended* that Lord was selling and that the corporation was buying the six hundred shares. Not only was there no reference to a dividend in the records evidencing the transaction, but the statements made tend to exclude and to render impossible the thought of a dividend." (Record, page 33.)

Considered either as a sustaining of the board's findings or as its findings, it is difficult to perceive how the Supreme Court could have been any more definite upon the question of "the intention of the parties." These findings were based upon abundant evidence. The record is replete with evidence supporting the same (Record, pages 41 to 45, 48, 49, 55, 56, 61, 65 to 73, 90 to 93, 100, 104, 108 to 111, 127, 132, 133, 135, 137, 149 to 151, 197, 198, 201, 205, 230 and 268).

This Honorable Court recently decided that intention

is a question of fact. The court also defined the weight to be accorded findings of fact upon appeals from the Supreme Court of Hawaii. It is stated in *Kapiolani Maternity and Gynecological Hospital v. Wodehouse,* 70 F. (2d) 793, at page 801:

> "In a legal action involving issues of fact we have no power to review the finding of a jury or of a judge acting as a jury if there is sufficient substantial evidence to sustain the verdict or decision upon an issue of fact, notwithstanding the fact that there might be an overwhelming weight of evidence on behalf of the appellant and notwithstanding the fact that upon the record we might be disposed to take the opposite view as to the fact in issue to that taken by the trial judge or the jury. This is the general rule applicable to appeals in federal practice, and is applicable to appeals from the Supreme Court of Hawaii. See 28 USCA Sec. 225, and also a recent decision interpreting the statute which allows appeals from decisions of the Supreme Court of Hawaii and of Puerto Rico. Porto Rico Ry. Light & Power Co. v. Miranda (C.C.A.) 62 F. (2d) 479. In a case in equity we have power to consider the weight and effect of the evidence, but even in such cases we are largely influenced by the decision of the trial judge, particularly where the witnesses appear in court. We would be very reluctant to overturn a decision of the Supreme Court of Hawaii upon a question of fact where we have the power to do so, and it is because of this reluctance that we have called attention to the fact *that what we are asked to do in this instance is to determine a fact, namely, the intent with which a woman now deceased made a payment of money or caused a payment of money to be made* to persons in Hawaii. We would not hesitate to pass upon this question of fact if it were our duty so to do, but as we understand

our duty it is to decline to pass upon a question of fact in an agreed case and to call to the attention of the Supreme Court of Hawaii that the issue involved is one of fact."

The following authorities show that intent is a question of fact:

"Intent is a question of fact, provable like any other fact in issue.

Intent need not be proven by direct testimony, but may be inferred from the act itself and from the surrounding circumstances."

Vol. 3, *Nichols Applied Evidence,* 2614.

"A man's intention is a matter of fact, and may be proved as such."

Fisk v. Inhabitants of Chester, 74 Mass. (8 Gray) 506;

Kelly v. Cunningham, 83 Mass. (1 Allen) 473; *Commonwealth v. Walker,* 108 Mass. 309, 312.

"The state of a man's mind at a given time is as much a fact as is the state of his digestion. Intention is a fact."

Swift v. Rounds, 19 R. I. 527; 35 Atl. 45, 46; 33 L. R. A. 561; 61 Am. St. Rep. 791.

The Supreme Court of Hawaii after carefully considering the record before it in the case made this statement (Record, page 35):

"The conclusion is irresistible that irrespective of what the parties might have accomplished if they had pursued a different course, the transaction as it actually occurred was a sale and purchase and resulted in a profit to Lord in the sale of his stock."

We submit that the questions of fact as to the intention of the parties and as to what was actually accomplished are supported by the great weight of the evidence and should be affirmed.

3.

THAT THE AMOUNTS RECEIVED BY THE APPELLANT FROM THE CORPORATION, E. J. LORD, LIMITED, IN CONSIDERATION OF HIS SELLING TO THE CORPORATION 600 SHARES OF STOCK, WAS NOT A "DIVIDEND" WITHIN THE MEANING OF THAT TERM AS IT IS USED IN SECTION 1391 OF THE REVISED LAWS OF HAWAII 1925.

(a) *The Appellant's Argument.*

The appellant argues, from pages 11 to 37 of his brief, that the consideration received by the appellant was paid by the corporation and received by him as his distributive share of the profits and surplus of the corporation, and, was, therefore, received "as dividends", within the meaning of Section 1391, Revised Laws of Hawaii 1925. This same argument was made to the Territorial Board of Equalization (Record, page 17). The board found that the parties intended, and that the transaction, in fact, was a sale of the stock to the corporation (Record, page 18). It also found that no dividend was received by the appellant.

The same argument was made to the Supreme Court

(Record, pages 26, 32 and 34). The Supreme Court sustained the assessment and the board's findings and reached the same conclusion as the board. Every argument used by the appellant in its brief is disposed of in so careful and in so clear a manner by the Supreme Court that we do not feel that we can improve on its reasoning or language.

The appellant by taking only parts of the evidence away from the greater portion thereof, and by considering it by itself, argues that the board or Supreme Court *might* have found that the amount received by the appellant was intended as a "dividend" within the meaning of the statute. He does not consider all of the evidence. The minutes of the board of directors of E. J. Lord, Limited (Record, pages 134, 136, 138, 199), the carefully drawn agreement of December 13, 1929 (Record, page 65), the agreement of December 26, 1930 (Record, page 90), and the receipts signed by Lord (Record, page 83) are only lightly touched upon. Assuming, but not admitting, that there was evidence upon which to base a finding and that the board *might* have found that the amounts received by the appellant were intended as dividends, the fact remains that there was ample and abundant evidence upon which to base the finding actually made by the board that the amounts received were intended as a consideration for the sale of stock. As heretofore pointed out, such a finding should not be disturbed.

The argument, repeatedly made throughout the appellant's brief, that Lord's share of the net profits of the cor-

poration was 60%, that he agreed to sell his stock for a consideration consisting in part of 60% of the said net profits together with his 60% interest in the corporation's plant and 60% of the profits on uncompleted contracts, is contrary to the evidence. The resolution adopted at the meeting of the corporation's board of directors (Record, page 135), and the formal agreement of December 13, 1929 (Record, page 65) clearly show, as pointed out by the Supreme Court, that a part of the consideration for the sale should be a sum of money *equal* to sixty per cent of the net worth of the corporation, "which net worth must have necessarily included capital as well as the undistributed profits", and "a sum of money *equal* to sixty per cent of the net profits to accrue in the future from contracts then uncompleted. They did not say that it should be sixty per cent of the net profits, but did say that it should be a sum of money equal to sixty per cent of the net profits" (Record, page 33). Why should this careful differentiation be drawn in the resolutions and agreement, if the transaction was intended as a dividend? Assuming that a dividend could have been declared and paid in this manner, the parties would have merely had to state that it was to be sixty per cent of the profits. The language used clearly shows that a sale, not a dividend, was intended. When this foundation is removed from the appellant's argument the entire argument falls.

Moreover, why should any agreement be entered into for the declaration and payment of a dividend? The corporation had paid dividends almost from its inception.

The dividends were declared and paid as dividends are ordinarily declared and paid, namely, by resolutions adopted at its directors' meetings (Record, pages 196 and 198). Such dividends were declared and paid during the years 1929 and 1930 (Record, pages 197 and 198). We submit, that this totally different practice shows that the amounts paid were not a dividend.

Furthermore, as pointed out by the Supreme Court, (Record, page 32) nowhere throughout the corporation's minutes, its books of account, the formal agreement, the receipts, or other evidence was there the slightest reference to a dividend declared or paid. The essence of the transaction, as disclosed by the evidence was that the appellant sold to the corporation his 600 shares of stock.

The Supreme Court also points out that although said Section 1391 provides an exemption in favor of amounts received from a corporation "as dividends upon the stock" of a corporation, the appellant relinquished his stock (Record, page 34).

As stated by the Supreme Court while it may be legally possible for only one shareholder to receive a dividend, that arrangement, when claimed to exist should at least be shown by clear evidence. Black, the other stockholder, received no dividend equivalent to that received by Lord. A dividend could as well have been paid to Black and the money by him later reinvested in his corporation but that was not the course that was followed (Record, page 34).

The reasons for the transaction appear to have been

that, on the one hand, Lord was in poor health and was having domestic difficulties which caused him to wish to retire from business (Record, page 56), while, on the other hand, Black had an ambition to form and control a corporation of his own (Record, page 201). These do not appear to be reasons for declaring and paying a dividend to Lord, but rather reasons for Lord selling his stock so he could retire and so Black could control his own corporation. The testimony of Black quoted and commented upon on pages 13 and 14 of appellant's brief consists of the loose language of a man who stated that he was not an accountant or an attorney (Record, page 201). He made statements, other than that quoted, to the effect that the transaction was a sale of stock by Lord to the corporation. (Record, page 205). Buchholtz's testimony is the same (Record, page 100).

The appellant argues on pages 18 to 21 of his brief, that if the parties had desired simply a purchase and sale of stock they would have taken into consideration all of the elements that determine the value of stock and on that basis would have reached an agreement to pay a fixed sum. It is further stated that "the significant thing about the entire transaction is that there never was any attempt by the parties to reach and agree upon that value." The parties did take into consideration all of the elements that determine value. This all appears from the testimony of appellant's own witnesses—Mr. Peters (Record, pages 57, 58, 60, 76, 78 to 80, 88, 89, 93 and 94). The appellant's brief contains similar statements (Brief, page 20).

The argument contained on pages 21 to 24 of appellant's brief is founded on the premise that there was an agreement to pay and that payment was made to the appellant of "60% of the net profits." As heretofore stated, that was not the case. Moreover, the appellant disregards, in making such an argument, such important evidence as the resolutions adopted by the corporation's directors, the formal agreement of December 13, 1929, and his own receipts.

It is stated on pages 22 and 23 that the parties could have followed one of two courses in determining the amount to be paid to him, namely, estimate the amount of profits on uncompleted contracts, or wait until the profits were determined. We agree with that. However, it does not follow that because the parties agreed that payment should be made when the contracts were completed and the profits were determined that the transaction did not constitute a sale of stock. Such a method is often used in making a sale.

Assuming that the case of *F. G. Lamb,* 14 B. T. A. 814, cited on page 25 of appellant's brief, was correct in respect to the facts there involved, it has no application to the evidence or findings in this case.

On the question of whether or not the payment of money to Lord was a "dividend" or was the consideration for the purchase of stock, the court said: "They did not say that it should be sixty per cent of the net profits but did say that it should be a *sum of money equal to sixty per cent of the net profits."* (Record, page 33). Section

3361, Revised Laws of Hawaii 1925 (Section 6747, Revised Laws of Hawaii 1935) provides that the directors of a corporation "shall not make dividends except from the profits arising from the business of the corporation". We submit that under territorial law a corporation may not declare a dividend out of the profits not yet earned. Although the Court conceded that it "may be legally possible for one only of two shareholders to receive a dividend, the other consenting to defer his dividend to a later time", still "that arrangement, when claimed to exist, should at least be shown by clear and convincing evidence; and in the case at bar there is no evidence whatever of any such arrangement."

(b) *Appellant's Authorities Discussed.*

There is no merit to appellant's contention that the amount received by him from E. J. Lord, Limited, was a dividend within the meaning of Section 1391, Revised Laws of Hawaii 1925. Most of the cases cited in his brief in support of this contention involve situations wherein dividends were paid to stockholders as a recurrent return on their investment, or wherein payments were made to stockholders upon liquidation or dissolution of the corporation. The appellant has failed to bear in mind the fact that he *ceased* to be a stockholder when the transactions with the corporation were consummated, *and that there was no dissolution* of E. J. Lord, Limited, or of E. E. Black, Limited.

Thayer v. Burr, 119 N. Y. S. 755, at 757, held that

extraordinary dividends declared by a corporation came within the meaning of "dividends" as used in a will directing that the dividends be paid to a certain beneficiary, as distinguished from distributions of "capital."

We have no quarrel with the statement taken from *Trefry v. Putman,* 222 Mass. 522, 116 N. E. 904 at 912, as given in Appellant's Brief (pages 26 and 27), but we do feel that the statement would be clarified by calling the court's attention to the language immediately following the statement:

> "Moreover, it is expressly provided in the income tax law (section 2) that:
>
> 'No distribution of capital, whether in liquidation or otherwise, shall be taxable as income under this section: *but accumulated profits shall not be regarded as capital under this provision*'."

It is submitted that the term "dividends" as used in *University v. N. C. R. R. Co.,* 76 N. C. 103, 22 Am. Rep. 671 at 672, can have no application or bearing upon the definition of dividend as that term is used in our income tax laws.

The case of *Eyster v. Centennial Board,* 94 U. S. 500, 24 L. Ed 188 at 189, has no application as shown by the sentences following the quotation used by appellant.

The *Spencer, Smith, Hartley, Norton, Travis, Thompson* and *Barnes* cases (brief, pp. 27-28) contain various rules and definitions concerning dividends issued in fact or by operation of law, but they have no application to the facts of this case.

The factual situation in *Hadley v. Commissioner,* 36 F. (2d) 543, prompts us to make but one comment. The Court decided that under the circumstances presented a tax assessment against a stockholder was proper because money credited to his account was a dividend received as the term "dividend" is defined in section 201 (a) of the Revenue Act of 1918. To the same effect are *Chattanooga Sav. Bank v. Brewer,* 17 F. (2d) 79, and *Christopher v. Burnet,* 55 F. (2d) 527.

There is nothing in *Commissioner v. Ward,* 65 F. (2d) 758, to sustain the appellant's contention that the money received by the appellant was a dividend. The case involves the federal income tax law. (Revenue Act of 1924). The term "dividend" as defined in Section 201 (a) and Section 234 (a) thereof provides a deduction of amounts received as dividends in computing net income. The Treasury Department ruled that profits of a building and loan association, periodically credited to its members, and payable to the member upon his retirement from the association, are to be treated as "dividends" within the meaning of Section 201 (a). This is merely authority for the rule that accumulated profits credited periodically until building and loan shares mature constitute dividends under the federal law.

The case of *Phelps v. Commissioner,* 54 F. (2d) 289, is hereinafter discussed.

That the appellant's authorities have but little bearing upon the instant case is disclosed by the statement contained on page 30 of his brief, that

> "We know of no state cases dealing specifically with the problem here involved. Most of the federal cases are inapplicable for the reason that almost every Revenue Act has made specific provision for the treatment of cases of retirement of stock or corporate dissolution. Obviously the fact that Congress chooses to treat gains derived from these transactions in a certain way either as dividends or as capital gains—sheds no light on the question now at issue."

Assuming for the purpose of argument that a corporation may legally pay a dividend to one of its stockholders and not to the others, we submit that the Supreme Court of Hawaii correctly decided that if such an arrangement is claimed it should be shown by clear and convincing evidence. It said: (Record, page 34) "in the case at bar there is no evidence whatever of any such arrangement".

c—*The Amounts Paid to the Appellant were not a "Dividend".*

1. *Basis of assessment.*

The tax assessment against the appellant was predicated upon the following grounds:

(1) That the business of appellant in the year 1926 constituted a capital asset to him;

(2) That when he sold his business to E. J. Lord, Limited, a corporation, and a separate entity, he received in exchange therefor an equivalent capital asset, to-wit, 600 shares of the capital stock of E. J. Lord, Limited;

(3) That, as defined in Section 6729 of the Revised Laws of Hawaii 1935 (Revised Laws of Hawaii 1925, Section 3350), such shares of stock are deemed in law to

be personal property, and as personal property the same were held by appellant until he sold the same to the corporation, E. J. Lord, Limited;

(4) That under the provisions of the territorial income tax law and particularly that part of Section 1390, providing as follows: "the amount of sales of all movable property, less the amount expended in the purchase of or production of the same", the difference between what the taxpayer paid for these shares and what he sold them for, to-wit, $398,224.40, constitutes a taxable gain. It was conceded by the witness Camp, tax expert for the appellant, that the territorial income tax law imposes a tax on capital gains (Record, page 152). In fact all past administration of the income tax law has recognized the propriety of a tax on capital gains and deductions in case of capital losses. This view of the law was upheld in the case of *Ewa v. Wilder,* 26 Haw. 299, affirmed in 289 Fed. 664. If, therefore, this stock was a capital asset to appellant and the transaction by which he disposed of that capital asset constituted a sale of his capital asset, it must follow that the gain resulting from such sale can be properly taxed.

The appellant, in his contention that a sale did not take place, has confused his status as a stockholder with that of the corporation. It is universally recognized that stock in a corporation constitutes personal property to the stockholder. Declaratory of the common law in this respect is Section 3350, Revised Laws of Hawaii 1925 (Section 6729 of the Revised Laws of Hawaii 1935). The

interest thus accruing to a stockholder by virtue of ownership of shares is separate and distinct from any interest in property owned by the corporation and vice versa. In the case of *Klein v. Board of Tax Supervisors of Jefferson County, Kentucky,* 282 U. S. 19, 51 S. Ct. 15, 75 L. Ed. 140, it is held that "stockholders are not the owners of the property of the corporation, the corporation itself being a person, whose ownership is a nonconductor, that makes it impossible to attribute an interest in its property to its members." Likewise in the same case, it is held that a state may tax both a corporation and the holders of the stock, and that the same will not constitute double taxation. In other words, there is no relationship between taxation of the stock of a corporation and taxation of the corporation property.

The general definition of "sale", contained in the Uniform Sales Act, Section 7360, Revised Laws of Hawaii 1935, is apropos as indicating what is generally understood by a sale. That definition is as follows:

> "A sale of goods is an agreement whereby the seller transfers the property in goods to the buyer for a consideration called the price."

In the case at bar, we have E. J. Lord, one entity, as the "seller", and E. J. Lord, Limited, a corporation, another entity, as the "buyer", engaging in a transaction whereby Lord as the "seller" transfers the property in stock owned by him to the corporation as the "buyer" for a consideration of $468,219.98. The record is replete with evidence, clearly showing that a sale took place. The

Board of Equalization came to this conclusion after hearing all the witnesses and reviewing all the evidence. (Record, pages 15-17). The Supreme Court made similar findings.

In further support of this conclusion the record shows that no dividend was declared by the company representing the payment made to the appellant (appellant's witness Buchholtz, Record, pages 275-277).

In harmony with this reasoning, we desire to call the attention of the Court to the case of *Langstaff v. Lucas,* 9 F. (2d) 691, affirmed by the Circuit Court of Appeals for the Sixth Circuit, 13 F. (2d) 1022, and certiorari denied by the Supreme Court of the United States November 1, 1926, 71 L. Ed. 858, 273 U. S. 722. This case will be hereinafter discussed. The reasoning used by the court in that case is strikingly applicable to the issues at bar.

(d) *No "liquidating dividend" was paid.*

Throughout the hearing of this case before the Territorial Board of Equalization and later before the Supreme Court, the appellant contended that the payment made by the corporation to the appellant was in the nature of a liquidating dividend, and, as such came within the class of dividends specifically exempted from taxation under the provisions of said Section 1391 of the Revised Laws of Hawaii 1925, reading as follows:

> "Provided, further, that in assessing income of any person or corporation there shall not be included the amount received from any corporation as divi-

> dends upon the stock of such corporation if the tax of two per centum has been assessed upon the net profits of such corporation as required by this Chapter, nor any bequest or inheritance otherwise taxed as such."

Judging from the cases cited on pages 26 to 37 of appellant's brief the same contention is now being made to this Honorable Court.

Before proceeding to analyze the appellant's contention, the court's attention is particularly called to that part of the above proviso reading as follows: " * * * as dividends *upon* the stock of such corporation * * ". We particularly emphasize the word "upon", because as this word is used, it does not allow for the substitution of any words such as "in exchange for", or their equivalent, as would be required if we are to accept the contention of the appellant.

In an effort to bring appellant's income within the four corners of the exemption, he pierces the corporate veil, and quotes voluminously from the cases construing the federal law. We feel, as did the Supreme Court, that appellant is attempting to create a dividend where none in fact existed. His task is troublesome because in no part of the transaction between appellant and the corporation was the term "dividend" ever mentioned. On the contrary when appellant filed his federal income tax return, the transaction was classified as one involving the sale of capital assets (Record, pages 164-165) and a tax was paid by the appellant on the basis of a gain realized from such sale, computed in the same manner as the tax assessor in the instant case has computed the territorial tax.

It is stated by witnesses for the appellant that the reason why the transaction was not described as a distribution of liquidating dividends was because the appellant would have had to pay a higher tax because the gain resulting from the sale of capital assets carries but the normal tax, whereas a liquidating dividend is subject to not only the normal tax, but to a surtax in addition (Record, page 165). We submit that the appellant could only classify the transaction as a sale of capital assets.

Under the federal law a condition precedent to a liquidating dividend was dissolution. In the case at bar there was no dissolution of E. J. Lord, Limited, and accordingly no liquidating dividend can be claimed.

Great stress is asked by the appellant to be placed upon *Phelps v. Commissioner,* 54 F. (2d) 289. However, we believe and submit that this case supports the position of the Territory rather than the contention of the appellant. First, there was involved a question of fact which was determined by the Board of Tax Appeals. Second, the federal income tax law was being construed, the provisions and theory of which are not at all parallel to the territorial statute.

The decision of the Court says in part at page 292:

> *"It is quite probable,* as petitioners suggest, *that the sale of stock to a corporation by one shareholder would be considered as a sale rather than as a liquidating dividend,* for the act of one of several stockholders could not well be considered as evidence of an intention of all the stockholders; but in the instant case the Board evidently considered the concerted

action of all the directors and stockholders in the disposition of practically all the stock as *probative of intention of the company to liquidate,* and we think the Board was right in so considering it.

The intention of the parties weighs heavily in determining the nature of such transaction, and this intention may be fairly arrived at in the instant case by the acts of the parties. On December 27, 1922, the determination to act was first expressed, and it was made of record by resolution. It authorized the president to purchase for the company such amounts of the company's capital stock and at such prices—not to exceed $130 a share—as he might deem fit. Within four days from that date he bought and paid for all the stock, except 300 shares of his own, and at the highest price authorized. Within less than two weeks from the date of the resolution the board of directors had authorized a reduction of the capital stock to 300 shares, all of which were owned by Mr. Phelps. *The entire transaction was remarkable for its celerity and lack of discord, and impels the conclusion that it was a voluntary distribution by the stockholders of all the assets of the company.* The fact that Mr. Phelps received money for part of his stock and retained the remaining outstanding stock cannot militate against such conclusion. He was thereby, in effect, the owner of the undisposed of assets of the corporation, which consisted only of the Jefferson street property. Technically, as between the stockholders and the corporation, it was not a complete liquidation in the sense that all the assets had been converted into cash and distributed; but as between the stockholders themselves, for all practical purposes, there was in effect a complete distribution, which was evidently made by agreement of the parties and one which they were fully authorized to make. Breslin v. Fries-Breslin Co., 70 N. J. Law, 274, 58 A. 313; Joseph Goodnow & Co. v. Commissioner, 5 B. T. A. 1154; F. G. Lamb v. Commissioner, 14 B. T. A. 814."

We respectfully submit that appellant's statement on pages 31 and 32 of his brief is erroneous. It is said:

> "The Circuit Court of Appeals held, looking through the form of the transaction to its substance, that the essence of the transaction was not a sale of stock but was, to the extent surplus was distributed, a distribution of profits in the nature of a dividend."

The Circuit Court of Appeals did not in effect so hold. It did hold that the Board of Tax Appeals rightly classified the transaction according to the facts presented.

> "In each of the above cases the Board and the court, respectively, classified the transaction before it according to the facts presented, and we think rightly so. *Of course the facts in each case are different, and each case must be governed by its own facts.* It may be said, however, that the cases cited by petitioners herein support the rule that it is the duty of both the Board and the court to classify such transactions consistently with the facts presented. It will be observed that in the cases just discussed there was no effort on the part of any petitioner to give any particular name to the transaction until the hearing was had before the commissioner. In the instant case the order of procedure is somewhat changed, in that petitioner had given a name to the transaction before the issue was formed. But names mean nothing unless they are supported by the facts."

And this language is particularly applicable in the present case. We have the decision of the Board of Equalization which found as a fact that the transaction between Lord and the Company was a sale and not a distribution to him as a dividend. If Lord had, for the purpose of

escaping taxation, chosen to call the transaction a dividend and not a sale, and the board had so found, the question being one of fact would be closed, unless, of course, its decision was obviously incorrect. As the court said: "names mean nothing unless they are supported by the facts." The finding must stand.

In *Hellmich v. Hellman,* 276 U. S. 233, 72 L. Ed. 544, 56 A. L. R. 379, the Supreme Court of the United States in construing the Revenue Act of 1918, and Treasury Regulations 45 promulgated under the Act, held that distribution to stockholders of a corporation during its liquidation, out of gains and profits accumulated since February 28, 1913, are regarded as payments for stock and should be taxed to the stockholders as profits and not as "dividends" exempt from the normal tax. The Court said that the Treasury Regulations correctly interpreted the act as making section 201 (a) applicable to a distribution made by a going corporation to its stockholders in the ordinary course of business, and section 201 (c) applicable to a distribution made to stockholders in liquidation of the corporation, and that such interpretation was in accord with the rulings of the Board of Tax Appeals. A portion of the Treasury Regulation under discussion reads as follows:

> "A distribution in liquidation of the assets and business of a corporation, which is a return to the stockholder of the value of his stock upon a surrender of his interest in the corporation, is distinguishable from a dividend paid by a going corporation out of current earnings or accumulated surplus when de-

clared by the directors in their discretion, which is in the nature of a recurrent return upon the stock."

Although there is no question of liquidation in the case at bar, still the analogy is of importance in determining the present issue. The court's statement regarding the definition of "dividend" as that term is used in the income tax law, is clear. It said:

> "It is true that if sec. 201 (a) stood alone its broad definition of the term 'dividend' would apparently include distributions made to stockholders in the liquidation of a corporation—although this term, as generally understood and used, refers to the recurrent return upon stock paid to stockholders by a going corporation in the ordinary course of business, which does not reduce their stock holdings and leaves them in a position to enjoy future returns upon the same stock. See Lynch v. Hornby, 247 U. S. 339, 344-346, 62 L. Ed. 1149, 1151, 38 Sup. Ct. Rep. 543; and Langstaff v. Lucas (D. C.) 9 F. (2d) 691, 694."

No valid reason has been given by the appellant to show why the term "dividend", as used in the case at bar, should have any other meaning than its general and ordinary signification. The Supreme Court comments upon this. (Record, page 34.) Annual dividends were declared by E. J. Lord, Limited, from the time of its incorporation. (Record, pages 196-198.) In 1929 the company paid dividends totalling $150,000 to its stockholders, and in 1930 it paid a $25,000 dividend to E. E. Black. The appellant's witness, George Buchholtz, answered in the affirmative a question asked, referring to the $25,000 dividend,

"That was the only dividend of any character whatsoever declared in the year 1930?" (Record, page 198.)

We have no quarrel with the federal statutes or federal authorities cited by counsel interpreting the federal statute. To the extent the federal statute is comparable to our own statute, then and there only, are we ready to concede that it is of value in this controversy.

The term "liquidating dividends" first made its appearance in federal legislation subsequent to the year 1918. The necessity therefor arose because property belonging to taxpayers was being transferred to corporations of which the taxpayers were stockholders, they receiving stock in exchange for property transferred. Under the principle then accepted by the federal government, that no gain or loss arose from such an exchange, the result was that fictitious values of the property, so exchanged, were put on the books of the corporation and subsequent sales of the property so transferred to the corporation reflected gains or losses only in relation to these fictitious values. In order to correct this abuse, the Congress of 1921 passed an act closing the gap, and thereunder, regardless of what terminology may be used, the federal government taxes a normal tax and surtax against any distribution made by a corporation in liquidation. The great majority of the cases cited by the appellant deal with the efforts of the courts to uphold the congressional enactment and the books are full of decisions holding that distributions made in liquidation are really liquidating dividends, subject to the normal and surtax as that term is used and

defined in the federal statutes, and, in sustaining the tax, the courts have had occasion to brush aside subterfuges and all manner and means of circumventing devices. Consequently, when the federal government, as appears from the record (Record, page 165), accepted the return of the taxpayer as reflecting a sale of capital assets, it may be conclusively assumed that the transaction in question did not reflect a "liquidating dividend", as that term is known and used in the federal law. Otherwise the federal government would have refused to accept the return and would have classified the transaction as one of distribution of liquidating dividends and assessed the greater tax accordingly. But the taxpayer contends the payment was really a liquidating dividend as that term has been used in federal legislation. Assuming this premise, what value has it in the present controversy? We will later show that the term had no relation to the term "dividend" as that term was used in earlier federal statutes, particularly in the 1913 and preceding statutes (See *Langstaff v. Lucas,* 9 F. (2d) 691, *post*).

Turning to the territorial income tax law we desire to call the attention of the Court to the date of the enactment of the exemption proviso in question, to-wit, Section 1391 of the Revised Laws of Hawaii 1925. This date is 1901—many years before the term "liquidation dividend" was known to the federal law. There is no language in the territorial act justifying the contention that liquidating dividends is synonymous with the term "dividend" as used in Section 1391. It cannot be found because the term

"liquidating dividend" was unknown in taxation councils at the time the local statute was enacted. And, see Section 3361, Revised Laws of Hawaii 1925 (Section 6747 of the Revised Laws of Hawaii 1935), a statute in *pari materia* relating to dividends as that term was understood at the time the income tax statute became law; and see testimony of Harold C. Hill (Record, pages 257-261), and of Henry Glass (Record, page 234). We will not prolong this line of argument in view of the fact that the reasoning in the case of *Langstaff v. Lucas,* 9 F. (2d) 691, conclusively disposes of the contentions of the taxpayer. There it appeared that the Langstaff-Orm Manufacturing Company, a Kentucky corporation, had a surplus accumulated since the federal income tax law went into effect, and shortly before December 1, 1919, the two stockholders, owners of all the stock, decided to liquidate the corporation and transfer all of its assets to a partnership to be called the Langstaff-Orm Lumber Company, the two owners of the stock to become the owners of the partnership business. It was provided in the agreement that no part of the assets, including the surplus, so distributed should be to the use of the shareholders individually, but only to the use of the partnership. There was assessed against the plaintiff on account of his own half of the surplus received a normal tax and a surtax. The plaintiff paid the taxes under protest and brought an action to recover the amount so paid.

> "By an amended petition the plaintiff asserts that, even if the one-half of the surplus assignable to his

> stock in the corporation should be treated as taxable income accruing to him in the year 1919, yet it was *income in the nature of a dividend,* and therefore was not subject to the normal tax for that year, which amounted to $1,711.21 of the total of $3,886.68 assessed against him, and that therefore in any event he is entitled to recover against the collector the sum of $1,711.21, with interest from the date of its payment. The case is submitted on demurrer to the petition as amended."

It was held that the transfer of the corporation assets was made to the stockholders individually, and was taxable as income as to the surplus. The Court stated (at page 693) that plaintiff's contention that the transfer to the partnership in accordance with the agreement did not amount to a transfer to the individuals violated the most elementary principles of partnership law. And in disposing of the plaintiff's contention that the surplus received by him should be considered as a dividend, the Court said, commenting on Section 201 of the Revenue Act of 1918:

> "This section strips distributions made to stockholders in liquidation of a corporation of all disguises and declares that they shall be considered for what they in effect are—purchases of all their outstanding stock by the liquidating corporations, and not dividends as generally understood, and as defined in section 201, subsection (a), and as used in section 216. So construed, subsection (c) of section 201 puts the stockholder who holds his stock up to the time of liquidation, and then in effect sells it to the corporation, upon exactly the same footing as the stockholder who sells his stock to another during the operating life of the corporation. The latter unquestionably, under the act of 1918, was required to pay both the

> normal and surtax upon any profit realized by him in the transaction. That is all the former was required to do under the act as here construed.
>
> For the reasons stated, the court is forced to the conclusion that it was not intended by Congress that so-called liquidating dividends, to the extent of the profit received, should escape the normal tax. It necessarily follows that the court is of the opinion that the plaintiff has stated no cause of action, and the demurrer to the petition will be sustained."

As defined by Mr. Justice Pitney in the case of *Lynch v. Hornby,* 247 U. S. 339, 38 S. Ct. 543, 62 L. Ed. 1149, the word dividend as used in the Act of 1913 means:

> "In short, the word 'dividends' was employed in the act as descriptive of one kind of gain to the individual stockholder; dividends being treated as the tangible and recurrent returns upon his stock, analogous to the interest and rent received upon other forms of invested capital."

As the court said, "in other words, it is earnings paid to him by the corporation upon his invested capital therein, without wiping out his capital".

The case of *Zimmers v. City of Milwaukee,* 189 Wis. 269, 206 N. W. 178, is applicable to the case at bar. The plaintiff, Zimmers, and his family owned one-half of the outstanding capital stock of the Kalt-Zimmers Manufacturing Company. The other one-half was owned by members of the Kalt and Casper families. Dissension arose between the plaintiff and his family on the one hand and the Kalts and Caspers on the other hand, and in 1920 the plaintiff elected to sell his stock at a price fixed by the

Kalt-Casper group, which offer to sell was an option to the plaintiff arising out of the written agreement between the parties. The company had been prosperous and had a considerable surplus on hand. The purchase price was agreed upon and was paid from the assets of the company in the form of Liberty Bonds, War Saving Stamps, a note secured by a mortgage on the company's property, certificates of indebtedness belonging to the company and a promissory note of Kalt and Casper. This action was approved by a resolution adopted at a meeting of the board of directors. After the closing of the transaction the plaintiff signed a statement which recited the receipt by him of the Kalt-Casper promissory note "as constituting the balance of the purchase price" of the shares. The plaintiff made no recital of this transaction in his income tax return for 1920, and he was assessed and paid under protest an income tax on a profit of $60,638.52 which the assessing officers determined he had realized as a result of the sale of his shares. In an action to recover the tax paid the circuit court decided in favor of the defendant, and this decision was upheld by the Supreme Court.

It was contended on behalf of the plaintiff that the proceedings should be considered as a distribution in the nature of a dividend or a distribution of surplus assets among its stockholders and therefore, the company having paid an income tax upon the receipts and revenues making up such surplus, the dividends paid would not be subject to an income tax. It was further urged that the court go behind the mere face of the proceedings and determine

the real substance of the transaction. The court in reply to this contention said:

> "The language used in the recitals of the minutes of the proceedings, and of the resolution adopted by the stockholders and by the board of directors, makes no statement to the effect that it was thereby and then intended to distribute, as a dividend, the corporate assets to the respective stockholders as such and in proportion to their holdings. All the writings, including the declaration by plaintiff of October 28th in the adjustment of interest recited above, speak of the transaction as a purchase by the Kalt-Casper party of the shares of stock held by the Zimmers family, and of the entire amount to be paid as the purchase price.
>
> There is no showing made of entries on the books of the corporation, at or after the time of the transaction, tending to indicate that, by appropriate entries, it was treated by the company at that time as a dividend, as distinguished from an advance out of the property of the company for the furtherance of a purchase by one set of stockholders of the stock held by the other set, in order that the internal dissensions that had so long troubled the company might be ended — a consummation which the corporation might well and devoutly wish.
>
> The oral testimony, if such could properly be considered in determining the real effect of the transaction, was on both sides of the question; the plaintiff testifying that it was the purpose at that time to distribute the surplus of the company as a dividend. Mr. Casper and his counsel, who took part in the transaction, testified to the contrary. On that feature of it, therefore, of course, *it presented a question of fact, and the findings of the taxing officers with reference to such manifestly could not be disturbed.*"

And the following excerpts from the decision are deemed important as bearing on the case at bar:

> "Stress is laid by plaintiff upon the recital in the findings by the trial court to the effect that, upon the acceptance of the proposal by the Zimmers party that the Liberty Bonds, stamps, certificates of indebtedness, note, and mortgage were delivered by said corporation pursuant to said resolution, and the title to the same absolutely and irrevocably passed to and vested in the Zimmers faction, together with the promissory note of Kalt and Casper, arguing therefrom that it is in effect such a finding of fact, which must lead to the legal and logical conclusion that the title to this property passed directly to the plaintiff from the corporation, and never reached the person buying the Zimmers stock, and that this effect could only be reached by treating this as a dividend. We cannot, however, so construe this finding, nor could it control, if treated as a conclusion of law, because, if such, it would be, as we have indicated above, incorrect.
>
> We are therefore satisfied that no other reasonable construction can be given to the transaction between the interested parties in October 1920, than that it was a purchase outright at the designated price per share of the entire holdings of the Zimmers family by the Kalt-Casper party, in which transaction the company on its own behalf and for its own interest assisted in advancing to the Casper-Kalt party which happened to be the buyer under the option, thereafter exercised, some of its assets and pledged its credit."

4.

THAT THE AMOUNT RECEIVED BY THE APPELLANT FROM THE CORPORATION, E. J. LORD, LIMITED, WAS TAXABLE INCOME DERIVED FROM THE SALE OF 600 SHARES OF STOCK.

The arguments and authorities contained on pages 27 to 53 hereof.

5.

THE EXEMPTION CLAIMED BY THE APPELLANT SHOULD NOT BE CONSTRUED IN HIS FAVOR, BUT SHOULD BE STRICTLY CONSTRUED IN FAVOR OF THE GOVERNMENT.

The result of appellant's contention is that the statute in question should be construed favorably to the taxpayer. It is submitted that the construction claimed by the appellant is unsound and unsupported by persuasive authority in so far as it is claimed to be applicable to the issues of this case.

> *Corliss v. Bower,* 281 U. S. 376, 74 L. Ed. 916.
> *Cooley on Taxation,* Vol. 1 (4th Edi.) 1403-1408,

clearly crystallizes the general principle of law applicable as follows:

> "Sec. 672. *Strict construction—Rule Stated.* An intention on the part of the legislature to grant an exemption from the taxing power of the state will

never be implied from language which will admit of any other reasonable construction.

* * *

"Exemptions are never presumed, the burden is on a claimant to establish clearly his right to exemption, and an alleged grant of exemption will be strictly construed and cannot be made out by inference or implication but must be beyond reasonable doubt. In other words, since taxation is the rule, and exemption the exception, the intention to make an exemption ought to be expressed in clear and unambiguous terms, it cannot be taken to have been intended when the language of the statute on which it depends is doubtful or uncertain; and the burden of establishing it is upon him who claims it. Moreover, if an exemption is found to exist, it must not be enlarged by construction since the reasonable presumption is that the state has granted in express terms all it intended to grant at all, and that unless the privilege is limited to the very terms of the statute the favor would be extended beyond what was meant." (Citing many authorities including United States Supreme Court and numerous States.)

And see *Tax Assessor vs. Wood,* 18 Haw. 485:

"The proposition that exemptions from taxation are strictly construed, in other words, that taxation is the rule and exemption the exception is well settled. Bishop v. Gulick, 7 Haw. 627, 630; O. R. & L. Co. v. Shaw, 12 Haw. 76. As the United States supreme court puts it, 'a doubt is fatal to the claim' of exemption."

See also *O. R. & L. Co. vs. Shaw,* 12 Haw. 76, 77.
Bishop vs. Gulick, 7 Haw. 627, 630.

Under the rule of strict construction, it is obvious that the exemption claimed must be denied.

6.

THE COURT DID NOT ERR IN HOLDING THAT THE DIFFERENCE BETWEEN THE COST OF APPELLANT'S STOCK AND THE AMOUNT HE RECEIVED THEREFOR WAS TAXABLE.

(a) *The rule of Darlington v. Gray is not applicable to the case at bar.*

As heretofore stated, appellant's argument, contained on pages 37 to 46 of his brief, is founded upon matters having to do with the construction of Hawaiian statutes. The construction placed upon the statutes by the Supreme Court (Record, pages 35 to 37) is sound, and, we submit, should be followed.

As there stated:

> "* * * In the face of this language of the statute, the contention that the profits resulting from the sale of stock were not taxable on January 1931, because they did not wholly accrue during the year 1930, is untenable. The requirement of the statute was that in January 1931, liability would accrue for taxes on an income which was 'received' or 'derived' during the taxation period, which was the year 1930; and this is made even more clear with reference to the sales of movable property when the statute declares that in estimating the profits 'there shall be included * * * the amount of * * * less the amount expended in the purchase'. The legislature did not, in this connection, make any exception of those parts of the gain in value which did not accrue during the taxation year and the court cannot now make the exception."

Much that has been said on pages 36 to 39 hereof under the topic "basis of assessment" is applicable to appellant's argument.

The case of *Gray v. Darlington,* 15 Wall. 63, 21 L. Ed. 45, is relied upon by the appellant as decisive of the case at bar on the proposition that the Supreme Court of Hawaii erred in holding that the difference between the cost of his stock in 1926 and the amount he received therefor in 1930 was taxable. The statute in the *Darlington* case taxed "gains, profits and income *for* the year ending the 31st of December next preceding the time for levying, collecting and paying said tax". That this case has not been questioned or modified is correct. *Lynch v. Turrish,* 247 U. S. 219, 62 L. Ed. 1087. For this reason appellant argues that it is binding in the case at bar, and he attempts by placing emphasis on certain phrases appearing in the Act of Congress involved in the *Darlington* case (Act approved March 2, 1867) and by doing the same thing with respect to the territorial statutes here involved (Sections 1388 and 1390, Revised Laws of Hawaii 1925), to place the same construction on both.

It was held in *Hays v. Gauley Mountain Coal Co.,* 247 U. S. 189, 62 L. Ed. 1061, that the *Darlington* case was not controlling because the language of the statute there involved was different in material particulars. In distinguishing the two statutes the court said:

> "Gains, profits, and income *for* the year ending the thirty-first day of December next preceding (Act of 1867) conveys a different meaning from the entire net income * * * *received by it* * * * *during* such year

> (Act of 1909). The former expression, as this court held (15 Wall. 65, 21 L. Ed. 46), denoted 'such gains or profits as may be realized from a business transaction begun and completed during the preceding year', with the exceptions already mentioned. The expression 'income *received* during said year', employed in the Act of 1909, looks to the time of realization rather than to the period of accruement, except as the taking effect of the act on a specified date (January 1, 1909) excludes income that accrued before that date."†

The Hawaii Supreme Court noted and followed this distinction, citing the *Hays* case (Record, page 36). It was pointed out by the Court that the statute under consideration in the *Hays* case (Act of Congress of 1909) taxing income received by the taxpayer *"during* such year" is the "equivalent of the expressions used in our statute for the admeasurement of taxable income."

In *Ewa Plantation Company v. Wilder,* 26 Haw. 299, the tax assessor relied upon the *Darlington* case to support his contention that where securities had been purchased by the taxpayer during the years 1904-1917 for the par value of $100 per share, and were sold by the taxpayer at a loss of $60 per share in 1920, that the losses were *ascertained* in 1920, although not *sustained* in that year. The assessor contended that such losses could not be deducted from the taxpayer's total income received in 1920; that only losses sustained during the taxation period could be deducted. This is the converse of the situation now before this Court. The Supreme Court of Hawaii in the *Ewa Plantation* case held that the losses sustained by the tax-

† Emphasis supplied by the Court.

payer in 1920, through the sale of the securities, were deductible as losses in computing its income taxes for that year. Speaking of the *Darlington* case it said:

> "The United States Supreme Court in a recent decision (*Hays, Collector, v. Gauley Mountain Coal Co.,* 247 U. S. 189) distinguished the corporation excise tax of August 5, 1909, from the act of March 2, 1867, under which *Gray v. Darlington* was decided, and held that where property is sold by a corporation at an advance over the original purchase price the amount of the advance must be deemed to be a gain or profit for the purpose of computing income for taxation under the federal statute. See also *Merchants' Loan & Trust Co. v. Smietanka,* decided by the federal Supreme Court March 28, 1921, and Holmes, Fed. Taxes, p. 632." * * * (26 Haw. at 319).
>
> "There is a dearth of federal judicial authority on the question before us, due no doubt to the fact the federal government has uniformly acquiesced in the position here assumed by the taxpayers and which we deem to be the only fair and practicable method of ascertaining losses of the nature involved. It is a notorious fact that during the last decade all stocks and bonds throughout the world have violently fluctuated with the greatest frequency, often changing in value from time to time with kaleidoscopic rapidity. This fact alone would render it impossible to determine the actual time at which the losses were sustained by the taxpayers, if the method of ascertaining those losses proposed by counsel for the assessor were adopted, and would deprive the taxpayers of the benefit of deductions from gross income caused by losses which it is conceded they actually sustained." (26 Haw. at 321).

The Supreme Court of Hawaii in the instant case did

not overrule, *sub silentio, Castle v. Tax Assessor,*† 18 Haw. 129, as stated by appellant (brief, page 38), but it followed the ruling in *Ewa Plantation Company v. Wilder, supra,* affirmed, 289 Fed. 664. It also appeared in the *Ewa Plantation* case as stated by the court below (Record, page 36), that the plantation received a lump sum settlement in 1920 for damages to crops sustained in that year. A portion of the damaged crops involved were harvested and sold subsequent to 1920. The taxpayer took the position that this payment was attributable to the years in which the damaged crops were sold, and should be taxed as income for such years. Under the authority of the same taxing statute here involved, the court held that the money so received was taxable as income received in 1920. In its decision of that case the Hawaiian Supreme Court said, at page 319:

> "The decision of this court *In re Appeal of J. B. Castle, supra,* asserts a mere conclusion, entirely devoid of any reasons therefor except that it is based upon the decision in *Gray v. Darlington, supra,* a case involving the construction of the Revenue Act of 1867 (14 Stat. 477, c. 169)."

This court in upholding the construction placed upon the statute by the Supreme Court of Hawaii in the *Ewa Plantation* case, said:

> "The statute plainly provides that the return of the taxpayer shall include all 'gains, profits and income, derived from any source whatsoever during said taxation period.' Rev. Laws Hawaii 1915, Sec. 1307. The inference is not deducible from the deci-

† Also referred to as "In re Appeal of J. B. Castle."

> sions of the Supreme Court of Hawaii that income actually received in one year is not taxable as income of that year but is to be carried into the income of another year." (289 Fed. at 667.)

See, also, 61 C. J., p. 1580, Sec. 2331.

The time when gains are deemed to have been realized under the taxing laws is, we submit, correctly stated in *McLaughlin v. Alliance Ins. Co.,* 286 U. S. 244, 76 L. Ed. 1083, wherein it appears that:

> "* * * Realization of the gain is the event which calls into operation the taxing act, although part of the profit realized in one accounting period may have been due to increase of value in an earlier one. While increase in value of property, not realized as gain by its sale or other disposition, may, in an economic or bookkeeping sense, be deemed an addition to capital in a later period, see Merchants' Loan & T. Co. v. Smietanka, 255 U. S. 509, 65 L. Ed. 751, 15 A. L. R. 1305, 41 S. Ct. 386, it is nevertheless a gain from capital investment which, when realized, by conversion into money or other property, constitutes profit which has consistently been regarded as income within the meaning of the Sixteenth Amendment and taxable as such in the period when realized." (76 L. Ed. at 1086.)

In *Merchants' Loan & T. Co. v. Smietanka,* 255 U. S. 509, 65 L. Ed. 751, 15 A. L. R. 1305, 41 S. Ct. 386, the *Darlington* case and *Lynch v. Turrish, supra,* were relied upon to support a recovery of taxes paid under the Act of Congress, approved September 8, 1916, as amended by the act approved October 3, 1917, and the Supreme Court of the United States in refusing to follow those cases said:

"Gray v. Darlington, 15 Wall. 63, 21 L. Ed. 45, much relied upon in argument, was sufficiently distinguished from cases such as we have here in Hays v. Gauley Mountain Coal Co., 247 U. S. 189, 191, 62 L. Ed. 1061, 1062, 38 Sup. Ct. Rep. 470. The differences in the statutes involved render inapplicable the expressions in the opinion in that case (*not necessary to the decision of it*) as to distinctions between income and increase of capital.

In Lynch v. Turrish, 247 U. S. 221, 62 L. Ed. 1087, 38 Sup. Ct. Rep. 537, also much relied upon, it is expressly stated that, 'according to the fact admitted, there was no increase after that date (March 1, 1913), and therefore no increase subject to the law.' For this reason the questions here discussed and decided were not there presented." (65 L. Ed. 756.)

(b) *Shares of Stock are Movable Property within the meaning of Section 1390, Revised Laws of Hawaii 1925.*

The Supreme Court of Hawaii in its decision refers to Section 1390, which provides that in estimating gains, profits and income "there shall be included * * * the amount of sales of all movable property, less the amount expended in the purchase or production of same * * *." Appellant in his brief (page 43) argues that shares of stock do not come within the purview of that section because they should be considered as intangible property, and that the statute, in referring to movables, denotes only tangible property.

Section 3350, Revised Laws of Hawaii 1925 (Section 6729, R. L. 1935) provides:

> "The shares of the several members in the stock of any incorporated company, whether owning real estate or otherwise, shall be deemed in law personal property."

Shares of stock are, therefore, personal property by virtue of the above statute, and as the legislature has made no distinction between tangible and intangible property, we submit that the term "movable property" includes shares of stock.

In *Carter v. Hill,* 31 Haw. 264 (aff. 47 F. (2d) 869), the court treated securities, including shares of stock, and bank deposits as movable property within the meaning of Section 1390, although it held that the income therefrom was not taxable by the Territory where such property was held in New York by a resident of the Territory. The conclusion follows, therefore, that stocks and securities are considered as personal property (movable property) under the territorial tax laws.

Furthermore, it was held in *Castle v. Castle,* 267 F. 521, that under Section 2977, Revised Laws of Hawaii 1915, which provided that a married woman on the death of her husband was "entitled by way of dower to an absolute property in one-third part of all his *movable effects* in possession or reducible to possession at the time of his death," a widow was entitled to one-third of the proceeds of her husband's life insurance policies.

(c) *The Court below Determined Appellant's Liability for the Tax Assessed under Section 1388, Revised Laws of Hawaii 1925, and considered Section 1390 to show Legislative Intent.*

Frear v. Wilder, 25 Haw. 603, relied upon by the appellant (brief, page 43), held that Section 1307, Revised Laws of Hawaii 1915 (Section 1390, R. L. 1925) "merely prescribes the method to be pursued by the taxpayer in returning his gross income from which his net taxable income is to be computed," and that Section 1305, Revised Laws of Hawaii 1915 (Section 1388, R. L. 1925) "levies an income tax upon gains, profits and income derived from certain definite and plainly enumerated sources and fixes the rate of taxation."

The Supreme Court of Hawaii in its decision in the case at bar (Record, pages 35 to 36) stated that under Section 1388 "liability would accrue for taxes on income which was 'received' or 'derived' during the taxation period, which was the year 1930; * * *." The court then referred to Section 1390, which fixes the method to be followed by the taxpayer in returning his gross income. According to *Frear v. Wilder, supra,* Section 1390 is immaterial in so far as the question of tax liability is concerned, and it does not apply to "gains, profits and income" derived or received by the taxpayer during the taxation period, and that only Section 1388 does that.

The Supreme Court in the instant case determined the *liability* for the appellant's income tax under Section 1388, and then considered Section 1390 to show the legislative intent. It was not held that the tax liability was to be determined under the provisions of Section 1390 because after saying that: "The requirement of the statute was that in January, 1931, liability would accrue for taxes

on income which was 'received' or 'derived' during the taxation period, which was the year 1930;" the court went on to say, "this is made even more clear with *reference* to the sales of movable property * * *" as provided in Section 1390 (Record, page 35). Since the legislature had made no exception as to the time when such increment accrued, the court held that it could not make an exception.

Consequently, the distinction between these sections mentioned in *Frear v. Wilder, supra,* is not material.

The only question before the court in *Frear v. Wilder* was whether or not a Christmas gift to the taxpayer of shares of stock was taxable as income under the income tax laws. Income received as a result of the sale of "movable property" was not considered by the court, nor was the time when the income accrued to the taxpayer in issue.

7.

THAT THE TAX UPON THE INCOME OF THE APPELLANT FOR THE YEAR 1930 WAS CORRECTLY COMPUTED.

The appellant argues on page 46 "we may also mention one certain error in the computation of the tax. The tax is on income derived or received in 1930. But the evidence is that the payment of 40% of Lord's federal taxes—being $20,328.50—was not made until 1931; (Ex. 29, Rec. p. 108, Ex. 30, Rec. p. 109, Rec. p. 118), hence clearly no tax for the year 1930 was payable on that amount on any theory."

This issue is raised for the first time before this court.

A complete answer to this argument is that the appellant returned in his tax return the entire amount received from E. J. Lord, Limited (Record, pages 1 to 7). Under "income" it appears that the appellant received from E. J. Lord, Limited, during the year *1930,* $408,457.98. He claimed that it was exempt income. Under schedule "B" he stated that he received $60,000. This makes a total of $468,457.98—the total amount paid to him by E. J. Lord, Limited, for his stock.

Section 1393, Revised Laws of Hawaii 1925, provides in part:

> "Sec. 1393. Individual return. It shall be the duty of all persons of lawful age having an income of one thousand dollars ($1,000.00) or more, for any taxation period, from all sources, and of all corporations made liable to income tax, to make and render a list or return between the first and thirty-first day of January of each year, in such form as the treasurer of the Territory may direct, to the assessor of the division in which such persons or corporations reside, locate or do business, of the amount of their or its income, gains and profits as aforesaid; * * *."

Pursuant to this statute the appellant filed his return which showed the amount received from E. J. Lord, Limited. The aggregate amount of $468,457.98 included the amount of $20,328.50. Having returned the amount as having been received in 1930, appellant is in no position to complain upon it being assessed and taxed. His return is an admission. If his income was not correctly computed (which we do not admit) his own conduct was the

cause of the error. He never requested to amend his return in this particular, or to be permitted to file any other or corrected return.

In addition it appears from the record that if any amounts were received in 1931 they were merely adjustments on amounts already paid (Record, page 118).

Furthermore, it is possible that appellant's books were kept upon an accrual basis. The amount accrued in 1930 under the agreement dated December 26, 1930 (Record, pages 90 to 93). It provided "and the party of the first part (E. E. Black, Limited) will pay forty per cent (40%) of the federal and territorial income tax which shall be assessed against the party of the second part by reason of and resulting from the sale and transfer by him of said shares of E. E. Black, Limited."

8.

THE APPELLANT HAS WAIVED ANY OBJECTION TO THE COMPUTATION OF THE TAX.

In addition to what has been stated under the last point, it affirmatively appears that after the appellant returned the amount of $20,328.50 as having been received during the year 1930, he treated the same throughout the hearing before the Territorial Board of Equalization and later before the Supreme Court as being of the same character as the other amounts received from the sale of his stock.

Moreover, no claim was made to the Territorial Board of Equalization or the Supreme Court that the tax was erroneously computed in the respect mentioned. For that reason any objection was waived.

See: *Blair v. Oesterlain Machine Co.,* 72 L. Ed. 249, 275 U. S. 220;

Duignan v. United States, 71 L. Ed. 996, 274 U. S. 195.

9.

THE ASSIGNMENTS OF ERROR DO NOT RAISE FOR REVIEW THE QUESTION AS TO WHETHER THE TAX WAS CORRECTLY COMPUTED.

There is no assignment of error covering or raising the question as to whether the tax and the amount of appellant's income for the taxable year 1930 were correctly computed.

We submit that appellant's contention comes within the well settled rule as set forth in *Cyclopedia of Federal Procedure,* Vol. 6, page 677, that:

> "The court will restrict its consideration to questions and matters properly presented below and saved for review in some legal manner, and shown by the record."

This court stated in *Baldwin v. United States,* 72 F. (2d) 810, at page 812:

> "This court has repeatedly held that errors argued in the briefs but not assigned as error will not be considered. Holsman v. U. S. (C.C.A. 9), 248 F. 193, 198; Wight v. Washoe County Bank (C.C.A.), 251 F. 819; Pattis v. U. S. (C.C.A.), 17 F. (2d) 562."

To the same effect Mr. Chief Justice White said:

> "While it is not necessary, we deem it well to say, that in reviewing the action of the court below, we are, of course, confined to the record and the case therein made, and may not, as the result of mistaken suggestions as to the issues and proof, disregard our duty by deciding, not the case as made, but an imaginary one, wherein issues not made and not presented below would have to be supplied, and whereby conjecture and surmise must be indulged to replace the total absence of all proof on a particular subject."

Roura v. Government of the Philippine Islands, 218 U. S. 386, 54 L. Ed. 1080.

CONCLUSION

We respectfully submit that the decision and judgment of the Supreme Court of Hawaii should be affirmed.

Dated at Honolulu, T. H., this 1st day of May, 1935.

Respectfully submitted,

WILLIAM B. PITTMAN,
Attorney General, Territory of Hawaii.

JOSEPH V. HODGSON,
GEORGE P. KIMBALL,
JON WIIG,
Deputy Attorneys General, Territory of Hawaii.